41 Retirement Plans for Self-Employed

Self-employed persons and partners can take advantage of tax-sheltered Keogh retirement plans or simplified employee pension plans (SEP). Advantages flow from: (1) tax deductions allowed for contributions to the plan (a form of forced savings); (2) tax-free accumulations of income earned on assets held by the plan; and (3) in some cases, special averaging for lump-sum benefits paid from a Keogh plan on retirement.

If you have employees, you must consider the cost of covering them when setting up your plan. Most self-employed persons are considered key employees and may be subject to the restrictions for top-heavy plans discussed in this chapter.

SIMPLE Plans. Starting in 1997, you may be able to take advantage of a new type of retirement plan called a “SIMPLE Plan.” *See* ¶8.17 and the Supplement for details.

¶41.1 Who May Set Up a Keogh Plan

You may set up a self-employed retirement plan called a Keogh plan if you earn self-employment income from personal services and have *net earnings* (gross business or professional income less allowable business deductions). Income earned abroad and excluded from federal income tax is not considered earned income for purposes of the plan. If you are an inactive owner, such as a limited partner, you do not qualify to set up a Keogh plan—unless you receive guaranteed payments for services which are treated as earnings from self-employment.

If you control more than one business (own more than 50% of the capital or profits interest in a partnership or the entire share of an unincorporated business), then for years beginning before 1997 you must set up pension or profit-sharing plans for all businesses under your control. For years starting after 1996, this aggregation rule no longer applies.

Employees Who Are Self-Employed on the Side

If you are an employee-member of a company retirement plan, you may set up a Keogh plan if you carry on a self-employed enterprise or profession on the side. For example, you are employed by a company that has a qualified 401(k) plan to which you make salary deferrals. At the same time, you have a sideline consulting business. You may set up a Keogh plan based on your consultant earnings. Each plan is independent of the other. As an alternative to a Keogh plan, you may contribute to a simplified employee pension plan (SEP) as discussed in ¶41.4.

Partnership plans. An individual partner or partners, although self-employed, may not set up a Keogh plan. The plan must be established by the partnership. Partnership deductions for contributions to an individual partner's account are reported on the partner's Schedule K-1 (Form 1065) and deducted by the partner as an adjustment to income on Line 27 of Form 1040.

Including employees in your plan. You must include in your plan all employees who have reached age 21 with at least one year of service. An employee may be required to complete two years of service before participating if your plan provides for full and immediate vesting after no more than two years. You generally are not required to cover seasonal or part-time employees who work less than 1,000 hours during a 12-month period.

Your plan may not exclude employees who are over a certain age.

A plan may not discriminate in favor of officers or other highly compensated personnel. Benefits must be for the employees and their beneficiaries, and their plan rights may not be subject to forfeiture. A plan may not allow any of its funds to be diverted for purposes other than pension benefits. Contributions made on your behalf may not exceed the ratio of contributions made on behalf of employees.

CAUTION Deadline for Setting Up Keogh Plan or SEP

You must formally set up a Keogh plan in writing on or before the end of the taxable year in which you want the plan to be effective. For example, if you want to make a contribution for 1996, your plan must be set up on or before December 31, 1996, if you report on a calendar-year basis. If your plan is established by the end of 1996, you have up until the due date for filing your return, plus extensions, to make a deductible contribution within the limits of ¶41.5.

If you miss the deadline for setting up a Keogh plan, you may contribute to a simplified employee pension plan (SEP) set up by the filing deadline for Form 1040, including extensions. *See* ¶41.4 and ¶8.16 for SEP details.

¶41.2 Choosing a Keogh Plan

There are two types of Keogh plans: defined-benefit plans and defined-contribution plans, and different rules apply to each. A defined-benefit plan provides in advance for a specific retirement benefit funded by quarterly contributions based on an IRS formula and actuarial assumptions. A defined-contribution plan does not fix a specific retirement benefit, but rather sets the amount of annual contributions so that the amount of retirement benefits depends on contributions and income earned on those contributions. If contributions are geared to profits, the plan is a profit-sharing plan. A plan that requires fixed contributions regardless of profits is a money-purchase plan.

A defined-benefit plan may prove costly if you have older employees who also must be provided with proportionate defined benefits. Furthermore, a defined-benefit plan requires you to contribute to their accounts even if you do not have profits. The maximum annual retirement benefit for basing 1996 plan year contributions may not exceed $120,000 and the $120,000 limit may have to be reduced if benefits begin before the Social Security age, which is currently age 65. The $120,000 limit is subject to annual inflation adjustments. All plans of a controlled group of businesses are aggregated for purposes of the limitations applied to defined benefits. A defined-benefit plan or defined-contribution plan may take into account Social Security benefits for employees subject to technical nondiscrimination limitations.

A minimum coverage rule requiring that a plan must include at least 40% of all employees (or 50 employees if that is less) applies only to defined benefit plans for years beginning after 1996.

Setting up a trust for investing in Keoghs. If you are interested in following an aggressive investment policy for funds in your Keogh plan, you will set up a trust to receive Keogh contributions. You may name yourself or an independent trustee to oversee the plan.

If you use funds to buy nontransferable annuity contracts from an insurance company, use of a trust is optional. Premium payments may be made directly to the insurance company. The annuity contract may pay a fixed monthly income for life or for a fixed period of years, or may be a variable annuity contract. Life insurance can be included only if it is incidental to retirement benefits.

If you are investing in savings certificates, you need not set up a trust; you may use a custodial account with the bank.

CAUTION

Prohibited Transactions

As an owner-employee (owning more than 10% of the business), your dealings with the trust are subject to restrictions. You are generally subject to penalties if you borrow funds from the trust (¶41.9); buy property from or sell property to the trust; or charge any fees for services you render to the trust. These restrictions also apply to any member of your immediate family and any corporation in which you own more than half the voting stock, either directly or indirectly.

¶41.3 Top-Heavy Plan Restrictions

"Top-heavy" plan rules, which apply to corporate plans favoring "key employees," may also apply to a Keogh plan of a self-employed person. The top-heavy rules apply if more than 60% of the account balances or accrued benefits are for key employees; *see* the next column for the definition of key employees. Even if your Keogh plan is not currently considered top heavy, your plan may be disqualified, unless it includes provisions that would automatically take effect if the plan becomes top heavy. The major top-heavy restriction requires an accelerated vesting schedule. There is also a lower limit on benefits where a key employee participates in both a defined-contribution plan and defined-benefit plan.

Vesting. A top-heavy plan must provide either 100% vesting after three years of service or graded vesting at the rate of at least 20% after two years of service, 40% after three years of service, 60% after four years of service, 80% after five years of service, and 100% after six years of service. There may be an advantage in electing three-year vesting if you have a high turnover of employees.

The $150,000 pay limit. The first $150,000 of a self-employed person's net earnings in 1996 is considered in determining deductible contributions, whether or not the plan is top heavy. The $150,000 limit may be adjusted for inflation.

Distributions before age 59½ . The 10% penalty for distributions before age 59½ (¶7.14) applies whether or not the plan is top heavy. The penalty does not apply to distributions made because you are disabled. Other exceptions to the penalty are listed at ¶7.14.

The IRS has ruled that a tax-free rollover may be made when the Keogh plan is terminated. A timely rollover will avoid the 10% penalty on premature distributions if the recipient is under age 59½.

Retirement plan bonds. If you invested Keogh plan funds in Treasury Department Retirement Plan Bonds before May 1, 1982, you may redeem them at any time, even if you are under age 59½. To avoid immediate tax, a rollover may be made within 60 days to an IRA or qualified pension or profit-sharing plan.

Who are key employees? The above top-heavy restrictions apply if more than 60% of a defined-contribution plan account balances or more than 60% of the accrued benefits of a defined-benefit plan are for key employees. For the 1996 plan year, key employees are employees who at any time during the plan year own: (1) one of the 10 largest ownership interests and have compensation exceeding $30,000; (2) more than a 5% interest; or (3) more than a 1% interest and also earn compensation of more than $150,000. Officers are considered key employees for 1996 if they have compensation exceeding $60,000 (subject to annual inflation adjustments). Key employee treatment also applies if the employee was a key employee in any of the four preceding years under the applicable compensation limit for such year.

¶41.4 Choosing a SEP

Under a SEP (simplified employee pension plan), you may contribute to a special type of IRA more than is allowed under the regular IRA rules. Contributions do not have to be made every year. When you do make contributions, they must be based on a written allocation formula and must not discriminate in favor of yourself, other owners with more than a 5% interest, or highly compensated employees. Coverage requirements for employees are at ¶8.16. A salary reduction arrangement for employees may be provided under a qualifying SEP established before 1997, or under a SIMPLE plan established after 1996; *see* ¶8.17.

Deductible contributions to your personal SEP account may not exceed 13.0435% of your net earnings (less 50% of self-employment tax liability), as discussed at ¶41.5.

The deadline for both setting up and contributing to a SEP is the due date for your return, *including extensions*. Thus, if you have not set up a Keogh plan by the end of the taxable year (¶41.1), you may still make a deductible retirement contribution for the year by contributing to a SEP by the due date of your return.

¶41.5 Deductible Keogh or SEP Contributions

The deductible limit for a Keogh plan depends on whether you have a defined-contribution plan (profit-sharing or money-purchase pension plan) or a defined-benefit plan. A SEP is treated as a profit-sharing plan for purposes of the deduction computation rules.

If you have a defined-benefit plan, you generally may deduct contributions needed to produce the accrued benefits provided for by the plan. This is a complicated calculation requiring actuarial computations that call for the services of a pension expert.

DEDUCTIBLE CONTRIBUTION RATE FOR A DEFINED-CONTRIBUTION KEOGH PLAN OR A SEP

Before figuring the deductible contribution you can make for 1996 to a profit-sharing Keogh or SEP account, or to a money-purchase pension plan, you must first figure your self-employment tax liability on Schedule SE and the 50% deduction for self-employment tax to be claimed on Line 25 of Form 1040. In computing your deductible plan contribution, your net profit from Line 31 of Schedule C, Line 3 of Schedule C-EZ, or Line 36 of Schedule F is *reduced* by the deduction for 50% of self-employment tax; *see* the Example in the next column.

As a self-employed person, you are not allowed to figure the deductible contribution for yourself by applying the contribution rate stated in your plan. The rate must be reduced, as required by law, to reflect the reduction of net earnings by the deductible contribution itself. If your plan rate is a whole number, you need not make the computation. Use the table below, which provides an adjusted decimal to apply to net earnings to figure the deductible contribution.

Self-Employed Person's Rate Table

If plan rate is—	*The adjusted decimal rate is—*
1%	.009901
2	.019608
3	.029126
4	.038462
5	.047619
6	.056604
7	.065421
8	.074074
9	.082569
10	.090909
11	.099099
12	.107143
13	.115044
14	.122807
15*	.130435*
16	.137931
17	.145299
18	.152542
19	.159664
20	.166667
21	.173554
22	.180328
23	.186992
24	.193548
25**	.200000**

* The maximum deduction percentage for contributions to your own profit-sharing Keogh account or to your own SEP account is 13.0435%. For your employees, the maximum rate is 15%.

** The maximum deduction percentage for contributions to your own money-purchase Keogh plan is 20%; for employees it is 25%.

Fractional rates. If the plan rate is fractional and thus not listed in the table above, figure your deductible percentage this way:

1. Write the plan rate as a decimal. For example, if the plan rate is 10.5%, write .105 as the decimal amount.
2. Add 1 to the decimal rate. For example, if the rate is .105, the result is 1.105.
3. Divide Step 1 by Step 2. This gives you the deductible percentage. If the plan rate is .105, the deductible percentage is .095023 (.105 ÷ 1.105).

Steps for figuring your maximum deductible contribution. After figuring your net earnings and reducing that amount by 50% of your self-employment tax liability, you multiply the balance by the rate from the Self-Employed Person's Rate Table or the fractional rate as previously discussed. However, your deduction for 1996 contributions may not exceed the *lesser* of (1) $30,000 and (2) $150,000 multiplied by the stated plan contribution rate (left column of Self-Employed Person's Rate Table). $150,000 is the maximum amount of compensation that can be taken into account for 1996.

The following Example illustrates the computation of the maximum deductible contribution.

EXAMPLE

You are a sole proprietor with no employees and have a profit-sharing plan which provides for a 15% contribution rate. Your net self-employment earnings for 1996 from Line 31 of Schedule C are $147,000 and you claimed a 50% deduction for self-employment taxes of $5,856 (½ of $11,712, self-employment tax from Schedule SE) on Line 25 of Form 1040. Your maximum deductible profit-sharing contribution is $18,410:

Step 1.	Net earnings reduced by 50% of self-employment tax liability ($147,000 – $5,856)	$141,144
Step 2.	Decimal rate from the table in the left column	.130435
Step 3.	Decimal rate multiplied by reduced net earnings ($141,144 × .130435)	$18,410
Step 4.	Overall contribution limit: $150,000 multiplied by 15% plan rate, but no more than $30,000	$22,500
Step 5.	Lesser of Step 3 and Step 4. This is your maximum deductible contribution	$18,410

Money-purchase plan may supplement profit-sharing plan. A money-purchase plan requires an employer to make fixed contributions each year, without regard to profit.

As shown in the table in the left column, the maximum deduction percentage for a money-purchase plan is 20% (25% for regular employees).

To maximize your deductible contributions, you may establish a separate money-purchase plan to supplement a profit-sharing plan. A bank or other Keogh plan trustee can help you set up separate plans and stay within the overall contribution limit of 20% of net earnings.

Contributions for your employees. The deduction complications that apply to your own contributions do not apply to contributions for employees. You make contributions for your employees at the rate specified in your plan, based upon their 1996 compensation (but not to exceed the lesser of $30,000 and $150,000 multiplied by the plan contribution rate). Thus, in the Example on the preceding page, you would contribute 15% of your employees' pay to the plan. You deduct contributions for employees when figuring your net earnings from self-employment on Schedule C or Schedule F before figuring your own deductible contribution using the steps shown on the E xample above.

Contributions after age 70½. You may continue to make contributions for yourself as long as you have self-employment income. If you have reached age 70½, you generally have to begin to receive minimum distributions from the plan no later than April 1 of the year following the year you reach age 70½; *see* ¶7.13. A penalty may be imposed if the minimum distribution is not received. The minimum distribution must be based on your life expectancy. If you are married, withdrawals may be spread over the joint lives of you and your spouse. Use the IRS actuarial tables to figure life expectancy, as explained at ¶7.23.

The same age 70½ minimum distribution rules apply to your employees.

Excess and unused contributions. Contributions to a profit-sharing plan exceeding the 13.0435% deduction ceiling (15% for your employees) may be carried over and deducted in later years subject to the ceiling for those years. However, if contributions exceed the deductible amount, you are generally subject to a 10% penalty on nondeductible contributions that are not returned by the end of your tax year. The penalty is computed on Form 5330, which must be filed with the IRS by the end of the seventh month following the end of the tax year.

If you contribute less than the allowable deduction limit for a profit-sharing plan, you may not carry forward the unused limit to a later year. However, the deduction limit for years after 1986 is increased by any unused pre-1987 carryforwards, but the increased limit may not exceed 20% of net earnings (25% of pay for employees).

¶41.6 How To Claim the Deduction

Contributions made to your Keogh or SEP account as a self-employed person are deducted as an adjustment to gross income on Line 27 of Form 1040. A deduction for a contribution made for your benefit may not be part of a net operating loss.

Contributions for your employees are entered as deductions on Schedule C (or Schedule F) for purposes of computing profit or loss from your business. Trustees' fees not provided for by contributions are deductible in addition to the maximum contribution deduction.

Deductible Keogh plan contributions may generally be made at any time up to the due date of your return, including any extension of time. However, the plan itself must be set up before the close of the taxable year for which the deduction is sought. If you miss the December 31 deadline for setting up a Keogh plan, you have at least up to April 15, 1997, to set up a SEP for 1996. If you have a filing extension, you have until the extended due date to set up a SEP and make your contribution.

¶41.7 How To Qualify a Plan

You may set up a Keogh plan and contribute to it without advance approval. But, since advance approval is advisable, you may, in a determination letter, ask the IRS to review your plan. Approval requirements depend on whether you set up your own administered plan or join a master plan administered by a bank, insurance company, mutual fund, or a prototype plan sponsored by a trade or professional association. If you start your own individually designed plan, you apply for a determination letter on Form 5300 whether the plan is a defined-benefit plan or defined-contribution plan. You must pay a fee to the IRS when you apply for a determination letter. File Form 8717 showing your fee, together with Form 5300.

If you join a master or prototype plan, the sponsoring organization applies to the IRS for approval of its plan. You should then be given a copy of the approved plan and copies of any subsequent amendments.

To set up a SEP with a bank, broker, or other financial institution, you do not need IRS approval. If you do not maintain any other qualified retirement plan and other tests are met, a model SEP may be adopted using Form 5305-SEP. To adopt a SEP with a qualifying salary reduction arrangement (¶8.16), you may be able to use Form 5305A-SEP.

¶41.8 Annual Keogh Plan Return

Partial relief from one burdensome IRS paperwork requirement may be available if your pension or profit-sharing Keogh plan covers only yourself, or you and your spouse, or you and your business partners and spouses. Such plans are treated as one-participant plans by the IRS.

One-participant plans that hold more than $100,000 at the end of any plan year beginning on or after January 1, 1994, must file a Form 5500-EZ for the first year the assets exceed $100,000 and for each year thereafter, even if total plan assets are reduced to $100,000 or less. For example, if plan assets in a plan that otherwise satisfies the requirements for filing the Form 5500-EZ totaled $110,000 at the end of the 1994 plan year, and a distribution occurred in 1996 so that plan assets totaled $85,000 at the end of the 1996 plan year, a Form 5500-EZ must be filed for the 1996 plan year.

The Form 5500-EZ due date for a 1996 calendar-year plan is July 31, 1997, unless an extension is obtained from the IRS.

The $100,000 exception applies if you, or you and your spouse, are sole proprietors or sole shareholders of a corporation maintaining the plan. The exception also applies if your business is operated as a partnership and the only plan participants are partners and their spouses.

You must file Form 5500-EZ for the final plan year regardless of the amount of plan assets.

If you cannot use Form 5500-EZ, you must file Form 5500-C/R if there are fewer than 100 plan participants (Form 5500 if 100 or more participants). On Form 5500-C/R, you check a box indicating whether the form is being filed as a Form 5500-C or Form 5500-R. Form 5500-R is a shorter form that may be used for a plan year that is *not* the first plan year or final plan year, provided that you used the longer Form 5500-C for at least one of the two prior plan years. Thus, after the first year, Form 5500-R may be filed in two of every three years. Only some of the Form 5500-C/R pages are filled in by Form 5500-R filers; follow the form instructions. The form must be filed by the end of the seventh month following the end of the plan year. There are penalties for late filing, unless you show reasonable cause or an extension is obtained; follow the Form 5500-C/R instructions for extension rules.

Electronic filing allowed. Forms 5500-EZ and 5500-C/R may be filed electronically or on magnetic tape by qualifying tax return filers. To file electronically or on magnetic tape, the plan administrator must provide a signed declaration on Form 8453-E.

¶41.9 Restrictions on Loans

Keogh plan loans to an owner-employee (more than 10% ownership) are subject to prohibited transaction penalties. There are two penalties: (1) a 10% penalty (5% for transactions on or before August 20, 1996), and (2) a 100% penalty.

The 10% (or 5%) penalty applies in the year of the loan and in later years until the loan is repaid with interest. The penalty is figured on a fair market interest factor which is explained in the instructions to Form 5330. You are required to report loans to the IRS on Form 5330 and pay the 10% (or 5%) penalty when you file the form. Form 5330 must be filed within seven months after the end of the taxable year; *see* Form 5330 instructions for filing extension rules.

The 100% penalty is imposed if the loan is not repaid. The penalty may be avoided by repaying the loan within 90 days after the IRS sends a deficiency notice for the 100% tax. The 90-day period may be extended by the IRS to allow you a reasonable time for repayment.

Exception. If you are an owner-employee, you may apply to the Department of Labor for a special exemption from the prohibited transaction penalties.

Loans treated as taxable distributions. Self-employed individuals are taxable on certain loans from their Keogh plan under the same rules applied to regular employees, as discussed at ¶7.16.

Loans from SEP are prohibited. Borrowing from a SEP is a prohibited transaction under the IRA rules and will result in the loss of the account's tax-exempt status. The account will be treated as if it were distributed to you on the first day of the year; *see* ¶8.8.

¶41.10 How Keogh Plan Distributions Are Taxed

Distributions from a Keogh plan generally may not be received without penalty before age 59 ½ unless you are disabled or meet the other exceptions listed at ¶7.14. After reaching age 70 ½, you generally must begin to receive distributions by the following April 1, and penalties may apply if an insufficient distribution is received; *see* ¶7.13.

Qualifying lump-sum distributions are taxable under special averaging methods, or may be rolled over tax free to an IRA or other qualified plan; *see* ¶7.2 for details. Pension distributions from a Keogh are taxed under the annuity rules of ¶7.25, but for purposes of figuring your cost investment, include only nondeductible voluntary contributions; deductible contributions made on your behalf are not part of your investment. For 1996, the excess distribution penalty discussed at ¶7.15 generally applies to lump-sum distributions exceeding $775,000 and to pensions and annuity payments (plus IRAs) exceeding $155,000. Distributions received in 1997, 1998, and 1999 will not be subject to an excess distribution penalty.

If you receive amounts in excess of the benefits provided for you under the plan formula and you own more than a 5% interest in the employer, the excess benefit is subject to a 10% penalty. The penalty also applies if you were a more-than-5% owner at any time during the five plan years preceding the plan year that ends within the year of an excess distribution.

Other rules discussed at ¶7.1 to ¶7.16 apply to Keogh plans as well as qualified corporate plans.

After the death of a Keogh plan owner, distributions to beneficiaries may be spread over the periods discussed at ¶7.13.

SEP distributions. Distributions from a SEP are subject to the IRA rules at ¶8.8.